2015 Market Terms in Independent Sponsor Transactions

July 27, 2016

Survey of 2015 Deals

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Mezzanine Lender and Private Equity Fund	$5.6M	$580K (rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 8% IRR on invested capital	$500K paid to Equity Sponsors $580K paid to Independent Sponsor (rolled into equity)	5.5% of annual EBITDA capped at $500K per year split 60/40 between Independent Sponsor and Equity Sponsors
Mezzanine Lender	$7.5M	$500K (rolled closing fee)	6% promote on Equity Sponsor's equity (no catch-up)	Fully vested at closing	$650K paid entirely to Equity Sponsors ($500K rolled into equity)	5.0% of annual EBITDA with a floor of $275K per year Paid entirely to Independent Sponsor.

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Survey of 2015 Deals (cont.)

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Private Equity Fund	$2.0M	None	30% promote on Equity Sponsor's equity (no catch-up)	10% vested at closing Additional 2.5% vests between 1.25X and 1.5X MOIC Additional 2.5% vests between 1.5X and 2.0X MOIC Additional 5% vests between 2.0X and 2.5X MOIC Additional 5% vests between 2.5X and 3X MOIC Additional 5% vests if MOIC greater than 3.0X	$100K paid to Equity Sponsor $40K paid to Independent Sponsor	None

Survey of 2015 Deals (cont.)

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote	Vesting Terms of Promote Interest	Fees
Private Equity Fund	$5M	$900K (rolled closing fee)	30% promote on Equity Sponsor equity (no catch-up)	10% vests upon Equity Sponsor receiving return of capital plus 10% IRR Additional 10% vests upon Equity Sponsor receiving return of capital plus 20% IRR Additional 10% vests upon Equity Sponsor receiving return of capital plus 25% IRR	$900K closing fee paid to Independent Sponsor (rolled into equity) Management fee = 5.0% of annual EBITDA capped at $400K per year paid to Independent Sponsor Floor of $250K per year.

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Survey of 2015 Deals (cont.)

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Private Equity Fund	$5M	$150K (rolled closing fee)	20% promote on Equity Sponsor's equity Independent Sponsor receives $350K catch-up after Equity Sponsor receives return of capital plus 8% IRR	15% vests upon Equity Sponsor receiving 2.5X MOIC Additional 5% vests upon Equity Sponsor receiving greater than 2.5X MOIC	$150K paid to Independent Sponsor (rolled into equity)	$400K per year payable to Independent Sponsor
Private Equity Fund	$7.5M	$2.0M ($500K from rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	15% vested at closing Additional 5% vests upon Equity Sponsor receiving greater than 4.0X MOIC	$500K (rolled into equity)	Greater of $300K and 5% of EBITDA First $200K payable to Independent Sponsor Thereafter, split 50/50 between Equity Sponsor and Independent Sponsor

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Survey of 2015 Deals (cont.)

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Private Equity Fund	$2.25M	$950K ($300K from rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 6% IRR on invested capital	$300K (rolled into equity)	6% of EBITDA with cap of $500K Split 50/50 between Equity Sponsor and Independent Sponsor
Private Equity Fund	$5.25M	$360K (rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	10% vests upon Equity Sponsor receiving return of capital plus 10% IRR Additional 10% vests upon Equity Sponsor receiving return of capital plus 20% IRR	$475K total $360K to Independent Sponsor (rolled into equity) and $115K to Equity Sponsor	4% of EBITDA with a cap of $300K per year to Independent Sponsor

Survey of 2015 Deals (cont.)

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Private Equity Fund	$5.25M	$300K (rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 8% IRR	$350K total $300K to Independent Sponsor (rolled into equity) and $50K to Equity Sponsor	5% of EBITDA with a cap of $300K per year and floor of $150K per year to Independent Sponsor
Private Equity Fund	$17M	$500K (rolled closing fee)	10% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 8% IRR	$500K to Independent Sponsor (rolled into equity)	$500K per year to Independent Sponsor
Private Equity Fund and Mezzanine Lender	$19.7M	$300K	20% promote on Equity Sponsor's equity (subject to catch-up after Equity Sponsor receives 2.25X MOIC)	Fully vested upon Equity Sponsor receiving 1.5X MOIC	$625K to Independent Sponsor ($300K rolled into equity)	$500K per year to Independent Sponsor

Survey of 2015 Deals (cont.)

Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Fees
Private Equity Fund and Family Office	$5.45M	$20K	Up to 50% of promote on Equity Sponsor's equity (subject to catch-up after Equity Sponsor receives return of capital plus 15% IRR)	Independent Sponsor receives catch-up after Equity Sponsor receives return of capital plus 15% IRR, until Independent Sponsor has received an amount equal to 25% of distributions made to Equity Sponsor After catch-up, Independent Sponsor receives 25% promote on Equity Sponsor's equity until Equity Sponsor receives greater of 35% IRR or 2X MOIC Promote then increases to 50% (with second catch up equal to 50% of distributions made to Equity Sponsor after first catch-up)	$200K to Independent Sponsor 8% of EBITDA, subject to $250K floor and $750K cap Split 80/20 between Independent Sponsor and Equity Sponsor

Trends and Takeaways

- Independent sponsor-backed deals are becoming increasingly prevalent in lower middle-market transactions
  - Multiple categories of capital sources are looking to the independent sponsor model
- "Market" on the size of promote/carry opportunities for independent sponsors seems to have stabilized
  - 20% promote opportunity seems to be the norm
  - Hurdles to obtaining full 20% promote continue to vary greatly
  - Traditional GP model v. Pure Preferred Model
- Independent sponsors are required to invest more at closing
  - Greater share of closing and management fees
- Every deal and every investor is different – deal terms still depend greatly on who you partner with

Hot Topics and Questions for the Future

- Tax-efficient structures
- Increasing interest of family offices
- Who receives closing fees for add-on acquisitions?
- Deal Control and Operational Control
- Closing Risk and Busted Deal Expenses

Questions?

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INDEPENDENT SPONSOR TRANSACTIONS SURVEY

(Based on Katten's 2015 Representative Transactions)

Transaction	Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Transaction #1	Mezzanine Lender and Private Equity Fund	$5.6M	$580K (rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 8% IRR on invested capital	$500K paid to Equity Sponsors $580K paid to Independent Sponsor (rolled into equity)	5.5% of annual EBITDA capped at $500K per year split 60/40 between Independent Sponsor and Equity Sponsors
Transaction #2	Mezzanine Lender	$7.5M	$500K (rolled closing fee)	6% promote on Equity Sponsor's equity (no catch-up)	Fully vested at closing	$650K paid entirely to Equity Sponsors ($500K rolled into equity)	5.0% of annual EBITDA with a floor of $275K per year Paid entirely to Independent Sponsor.
Transaction #3	Private Equity Fund	$5M	$150K (rolled closing fee)	20% promote on Equity Sponsor's equity Independent Sponsor receives $350K catch-up after Equity Sponsor receives return of capital plus 8% IRR	15% vests upon Equity Sponsor receiving 2.5X MOIC Additional 5% vests upon Equity Sponsor receiving greater than 2.5X MOIC	$150K paid to Independent Sponsor (rolled into equity)	$400K per year payable to Independent Sponsor

Transaction	Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Transaction #4	Private Equity Fund	$2M	None	30% promote on Equity Sponsor's equity (no catch-up)	10% vested at closing Additional 2.5% vests between 1.25X and 1.5X MOIC Additional 2.5% vests between 1.5X and 2.0X MOIC Additional 5% vests between 2.0X and 2.5X MOIC Additional 5% vests between 2.5X and 3X MOIC Additional 5% vests if MOIC greater than 3.0X	$100K paid to Equity Sponsor $40K paid to Independent Sponsor	None
Transaction #5	Private Equity Fund	$5M	$900K (rolled closing fee)	30% promote on Equity Sponsor's equity (no catch-up)	10% vests upon Equity Sponsor receiving return of capital plus 10% IRR Additional 10% vests upon Equity Sponsor receiving return of capital plus 20% IRR Additional 10% vests upon Equity Sponsor receiving return of capital plus 25% IRR	$900K paid to Independent Sponsor (rolled into equity)	5.0% of annual EBITDA capped at $400K per year paid to Independent Sponsor Floor of $250K per year.
Transaction #6	Private Equity Fund	$17M	$500K (rolled closing fee)	10% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 8% IRR	$500K to Independent Sponsor (rolled into equity)	$500K per year to Independent Sponsor

Transaction	Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Transaction #7	Private Equity Fund and Family Office	$5.45M	$20K	Up to 50% of promote on Equity Sponsor's equity (subject to catch-up after Equity Sponsor receives return of capital plus 15% IRR)	Independent Sponsor receives catch-up after Equity Sponsor receives return of capital plus 15% IRR, until Independent Sponsor has received an amount equal to 25% of distributions made to Equity Sponsor After catch-up, Independent Sponsor receives 25% promote on Equity Sponsor's equity until Equity Sponsor receives greater of 35% IRR or 2X MOIC Promote then increases to 50% (with second catch up equal to 50% of distributions made to Equity Sponsor after first catch-up)	$200K to Independent Sponsor	8% of EBITDA, subject to $250K floor and $750K cap Split 80/20 between Independent Sponsor and Equity Sponsor
Transaction #8	Private Equity Fund and Mezzanine Lender	$19.7M	$300K	20% promote on Equity Sponsor's equity (subject to catch-up after Equity Sponsor receives 2.25X MOIC)	Fully vested upon Equity Sponsor receiving 1.5X MOIC	$625K to Independent Sponsor ($300K rolled into equity)	$500K per year to Independent Sponsor

Transaction	Type of Equity Sponsor(s)	Equity Sponsor(s) Equity Investment	Independent Sponsor Equity Investment	Promote Interest	Vesting Terms of Promote Interest	Closing Fee	Management Fee
Transaction #9	Private Equity Fund	$7.5M	$2M ($500K from rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	15% vested at closing Additional 5% vests upon Equity Sponsor receiving greater than 4.0X MOIC	$500K (rolled into equity)	Greater of $300K and 5% of EBITDA First $200K payable to Independent Sponsor Thereafter, split 50/50 between Equity Sponsor and Independent Sponsor
Transaction #10	Private Equity Fund	$2.25M	$950K ($300K from rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 6% IRR on invested capital	$300K (rolled into equity)	6% of EBITDA with cap of $500K Split 50/50 between Equity Sponsor and Independent Sponsor
Transaction #11	Private Equity Fund	$5.25M	$360K (rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	10% vests upon Equity Sponsor receiving return of capital plus 10% IRR Additional 10% vests upon Equity Sponsor receiving return of capital plus 20% IRR	$475K total $360K to Independent Sponsor (rolled into equity) and $115K to Equity Sponsor	4% of EBITDA with a cap of $300K per year to Independent Sponsor
Transaction #12	Private Equity Fund	$5.25M	$300K (rolled closing fee)	20% promote on Equity Sponsor's equity (no catch-up)	Fully vested upon Equity Sponsor receiving return of capital plus 8% IRR	$350K total $300K to Independent Sponsor (rolled into equity) and $50K to Equity Sponsor	5% of EBITDA with a cap of $300K per year and floor of $150K per year to Independent Sponsor

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INDEPENDENT SPONSORS

Our Clients

Katten's Private Equity attorneys offer highly experienced counsel to independent sponsors, private equity funds, lenders, family offices, portfolio companies and other parties with interests in the growing independent sponsor space. We manage independent sponsor-led buyouts of companies in a wide variety of industry sectors, including retail, business services, industrial and consumer products.

Our Services

Our attorneys have handled a multitude of independent sponsor deals and have a history of representing all constituencies in independent sponsor transactions. Whether our group represents an independent sponsor, a mezzanine fund, a family office or a traditional private equity firm, we have the requisite experience and marketplace knowledge to provide thoughtful and creative advice to meet our clients' needs in the evolving and increasingly important independent sponsor transaction space.

With a multidisciplinary team, we are able to provide comprehensive services for deals involving independent sponsors, including developing tax-efficient structures, negotiating advisory and management fees, navigating governance issues, and assisting with commercial financing. In particular, Katten has significant experience in developing innovative solutions to accommodate complex economic arrangements between independent sponsors and other investors in a transaction, including promote and carried interest arrangements.

In addition, we leverage our wide-ranging experience in middle-market private company mergers and acquisitions to advise independent sponsors and their investors in acquiring and divesting portfolio companies. We provide counsel on issues that arise in nearly every M&A transaction, including general corporate and commercial, employment, benefits and compensation, labor relations, intellectual property, and environmental matters.

Our Experience

- Representation of BASE Equity Partners in its acquisition of all of the assets of Jolyn Clothing Company.
- Representation of Monroe Capital in the control acquisition of Soft Landing Interventions.
- Representation of an affiliate of BASE Equity Partners in the acquisition of a controlling interest in New York Packaging II.
- Representation of Modjule in the acquisition of Hickory Farms.
- Representation of North Branch Capital in the acquisition of Circuit Check, a designer and manufacturer of test equipment for electronics and electro-mechanical devices.
- Representation of OFS SBIC I, LP in connection with its purchase and financing of Mirage Trailers Holdings.
- Representation of BASE Equity Partners in its acquisition of A.C.T. Lighting, a distributor of lighting control consoles, lighting fixtures and cables for live

entertainment events, and the related senior and subordinated debt financings.

- Representation of a principal investment firm specializing in investing in small- to mid-sized companies in the business services sector in its acquisition of a health care information provider.
- Representation of a private equity firm in the purchase of all the outstanding membership interests of an insurance adjustor.
- Representation of Prairie Capital in the acquisition of Damac Products, a manufacturer of networking infrastructure products for the telecom and datacom markets.
- Representation of a private equity firm in the purchase of 70 percent of the outstanding interests in a management holding company.
- Representation of Prairie Capital in the acquisition of Captek Softgel, a manufacturer of custom dietary supplement formulations.
- Representation of a private investment firm in connection with the acquisition of an indoor greenhouse tomato-growing company based in Minnesota.
- Representation of Prairie Capital in the investment in the related acquisition of printer/manufacturer Double E.

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Structuring Equity Interests for Independent Sponsors

For more information, please contact any of the following Katten attorneys.

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In a traditional private equity fund, the fund managers will raise money from investors to establish a pool of capital the fund can then use to invest in a number of portfolio companies. A big benefit of a fund is that the fund managers can invest immediately in a new portfolio company (as the fund can call committed capital from investors at any time). One potential downside of a fund is that, if promising potential portfolio companies are scarce, the investors' money is still tied up and subject to management fees.

An increasingly popular alternative is the "fundless" or "independent" sponsor (the "Sponsor"), particularly in the lower middle market. Rather than finding the cash up front and then searching for investments, the Sponsor finds a promising company and then matches that company with investors. It provides a bit more flexibility to investors who don't want or can't afford to have their cash tied up in a traditional fund for years, or who want to be more selective about where their money goes. The Sponsor will often set up a limited liability company or limited partnership (which will be taxed as a partnership in either case) to serve as an investment vehicle for the deal. In exchange for its efforts, the Sponsor will often receive some combination of closing fees, management fees (if the sponsor provides services after closing), and an interest in the profits of the investment vehicle, as well as the opportunity to invest in the deal. Closing fees and management fees are usually compensation for services rendered, and are therefore generally taxed as ordinary income to the sponsor when received.

Sponsors commonly attempt to structure their deals to defer the receipt of taxable income and to receive capital gains income by waiving their closing fees in exchange for an equity interest in the investment vehicle, which only allows the Sponsor to share in the future appreciation of the portfolio company. The equity interest the Sponsor receives will typically be junior preferred equity or other securities which are junior to the capital of any private equity fund or other investor and are out of the money at closing. If structured properly, most of the income allocated to or realized by the Sponsor upon a sale of the portfolio company should be capital gain income (other than perhaps their share of amortization or depreciation recapture). However, such arrangements have come under scrutiny from the Internal Revenue Service (IRS) in recent years. The most important factor in regulations recently proposed by the U.S. Department of the Treasury is whether the arrangement contains "significant entrepreneurial risk" for the Sponsor. Such regulations contain a rebuttable presumption that certain arrangements are automatically disguised payments for services, including arrangements which are fixed or determinable, or otherwise designed to ensure profits will be allocated to the service provider no matter how the business does. Carried interest arrangements are especially troubling to the IRS if the service provider controls the portfolio companies, because then the service provider may be able to control when and how distributions are made. To be respected, these

arrangements must have real economic risk for the Sponsor, so that they do not receive cash on a down or sideways deal. Recent comments by officials at the IRS indicate that including a clawback provision for amounts distributed to the Sponsor is an easy way to show such risk. Additionally, the Sponsor rarely has control of the portfolio company, which is instead often controlled by a fund brought in as an investor; this lack of control gives more comfort to the IRS that the Sponsor faces actual economic risk on the deal.

A Sponsor who wants to avoid the fee waiver alternative (whether because of the enhanced IRS scrutiny or because the Sponsor's equity interest is subordinated to investors' capital and potentially preferred return thereon) may instead elect to structure the deal such that the Sponsor gets an equity interest that is on par with the investors' preferred equity. The Sponsor could successfully achieve this result if it has a valuable intangible asset, such as a business plan or signed letter of intent, which the Sponsor contributes to the investment vehicle, typically around the time of its formation. In exchange for this in-kind contribution, the Sponsor would receive an equity interest in the investment vehicle. The contribution of the letter of intent or other intangible property to the investment vehicle is intended to be treated as a tax-free contribution of appreciated property to a partnership for income tax purposes. The equity interest has to be received in exchange for the letter of intent, rather than in whole or in part as compensation for services rendered. If it is determined that a portion of the interest received by the sponsor is in exchange for services, the value of the portion of the interest so treated would be ordinary income to the sponsor.

Providing a Sponsor an interest in the investment vehicle, especially in lieu of fees or other compensation, requires careful planning and knowledgeable advisors to structure the deal properly. The determination of whether the interest received is a capital asset that does not immediately result in taxable ordinary income is dependent on the facts of circumstances of the particular deal in question.

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6/24/16

The Perils of Regulation by Prosecution:

Lessons from the Blackstreet Case

Almost seventy years ago, the Supreme Court was asked to consider whether the SEC was required to articulate new principles of law through rule-making rather than adjudication. Since the SEC has the power to use either tool, it was argued that rule-making should be used to prospectively change existing legal standards, while adjudication should be used to punish a person who violates a pre-established legal standard. The Supreme Court rejected this approach, giving the SEC broad discretion to regulate through prosecution rather than rule-making. However, the Supreme Court cautioned that:

> Since the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate new standards of conduct . . . . The function of filling in the interstices of the Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future.

SEC v. Chenery Corp., 332 U.S. 194 (1947).

Several benefits have been identified of rule-making over adjudication:

1. A rule formulated after rulemaking, "with its wider notice and broader opportunities for participation[,] is fairer to the class of persons who would be affected by a new 'rule' than" a rule announced in an adjudication. " Such broader participation also makes rulemaking more efficient as an information-gathering technique for the agency."

2. "Rulemaking is superior to adjudication as a means of making new law because rulemaking is normally prospective while adjudication normally involves prescribing consequences for past conduct or present status."

3. "The articulation of a generally applicable rule provides greater clarity to those affected as well as greater uniformity in enforcement."

4. "Rulemaking is more efficient from the agency's point of view because its procedures offer more flexibility, at least when the choice is between the notice-and-comment requirements of section 553 of the APA and the formal adjudicatory procedures of sections 554, 556, and 557 of the APA. Two of the most significant elements of this flexibility are the agency's broad control over the procedure for the presentation of information and argument and the agency's freedom to resort to its staff expertise without the inhibitions of separation of functions requirements."

5. "Since the agency is better able to control the scope and the pace of a rulemaking proceeding, use of rulemaking to formulate policy gives the agency better control of its agenda and enables it to define and to focus on the policy

issues without the distractions of individual adjudicative issues" or the need to wait for issues to arise in a case.

6. "Rulemaking is also more efficient for the agency because it can result in the adoption of a general principle which can thereafter be applied without reexamination," thereby eliminating the need for many case-by-case adjudications.

Richard K. Berg, Re-examining Policy Procedures: The Choice Between Rulemaking and Adjudication, 38 Admin. L. Rev. 149 (1986). One commentator has noted, however, that there are advantages to adjudication over rule-making:

1. Rulemaking's increasing procedural complexity can be avoided.

2. Modifications can be made more easily.

3. Conflict can be minimized.

4. Adjudicatory decisions can be situation-specific, thus potentially avoiding over-inclusiveness or under-inclusiveness.

Jeffery S. Lubbers, A Guide to Federal Agency Rule-Making (4th ed. 2006).

The Blackstreet settled enforcement case

The SEC's recent settled enforcement action in the Blackstreet case, Admin Pro. 3-17267 (June 1, 2016), illustrates the perils and limitations of regulation by prosecution.

Who Is a Broker-Dealer?

The press release issued by the SEC announcing the Blackstreet case highlighted that a "Private Equity Fund Adviser Acted As Unregistered Broker." SEC Press Release 2016-100 (June 1, 2016). The second paragraph of the press release then prominently stated that:

> An SEC investigation found that Blackstreet Capital Management and Murry N. Gunty performed in-house brokerage services rather than using investment banks or broker-dealers to handle the acquisition and disposition of portfolio companies for a pair of private equity funds they advise. Blackstreet fully disclosed to its funds and their investors that it would provide brokerage services in exchange for a fee, yet the firm failed to comply with the registration requirements to operate as a broker-dealer.

A week after the Blackstreet case, a senior SEC enforcement official confirmed that "[a]ny private-equity adviser that doesn't have a broker-dealer registration and is earning transaction fees—I'm not saying that's a violation—but it creates a question." "SEC Official Puts Broker-Dealer Issue Back on Private Equity's Radar," Wall Street Journal, June 7, 2016. The press release announcing the Blackstreet case and this subsequent statement by an SEC

enforcement official created great concern that an enforcement "crackdown" on unregistered brokers in the private equity industry is imminent.

The actual settled order in Blackstreet, however, contains virtually no information about why the SEC found that Blackstreet was acting as a broker-dealer. The summary section of the order contains two short sentences on the issue:

> In connection with the acquisition and disposition of portfolio companies or their assets, some of which involved the purchase or sale of securities, BCM provided brokerage services to and received transaction-based compensation from the portfolio companies. This activity caused BCM to be acting as a broker. BCM, however, has never been registered with the Commission as a broker.

The order then contains a single brief paragraph discussing the broker-dealer issue:

> Although the L[imited]P[artnership]A[greement]s expressly permitted BCM to charge transaction or brokerage fees, BCM has never been registered with the Commission as a broker nor has it ever been affiliated with a registered broker. Rather than employing investment banks or broker-dealers to provide brokerage services with respect to the acquisition and disposition of portfolio companies, some of which involved the purchase or sale of securities, BCM performed these services in-house, including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions. BCM received at least $1,877,000 in transaction-based compensation in connection with providing these brokerage services.

Neither the amount of the disgorgement nor the fine bear any apparent relationship to the $1,877,000 figure tied to deal fees.

There appear to have been three reasons why the SEC found the need for broker-dealer registration. First, the firm allegedly disclosed to its investors that it would provide brokerage services for a fee. Second, the adviser allegedly performed the following services, which are allegedly characteristic of brokerage activity: "soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions." Third, the adviser allegedly received transaction-based compensation for performing these services.

The settled order in Blackstreet leaves many questions unanswered and creates great confusion over why the SEC believed Blackstreet needed to be registered as a broker-dealer.

Section 3(a)(4)(A) of the Securities Exchange Act of 1934 defines a "broker: as "any person engaged in the business of effecting transactions in securities for the account of others." Two elements are generally viewed as necessary to require registration as a broker:

1. The receipt of transaction based compensation; and

2. Engaging in certain activities that are characteristic of effecting transactions in securities.

The Blackstreet case creates ambiguity on each element of the definition.

Although the settled order concludes without analysis that Blackstreet received "$1,877,000 in transaction-based compensation in connection with providing these brokerage services," this observation leaves many ambiguities. First, in the private equity context, so-called "deal fees" are in fact advisory fees rather than fees for actually effecting transactions in securities. Moreover, in a 2013 speech, David Blass, then the chief counsel in the SEC's Division of Trading and Markets noted that "[t]o the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, one might view the fee as another way to pay the advisory fee, which, in my view, in itself would not appear to raise broker-dealer registration concerns." "A Few Observations on the Private Equity Space," available at www.sec.gov/News/Speech/Detail/Speech/1365171515178. The Blackstreet case does not mention whether the "deal fees" were offset and whether, if that were the case, Mr. Blass's comments remain valid. Finally, since the amount of the disgorgement and fine bear no apparent relationship to the so-called "deal fees," it is unclear why.

With respect to the activities in which Blackstreet allegedly engaged - "soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions" – the settled order also leaves great ambiguity. For example, it is difficult to imagine Blackstreet "executed" securities transactions in the traditional sense. It is also unclear how some of these activities differed from an advisory function, which would normally be exempt from activity requiring broker registration.

It is also unclear whether the Blackstreet case is intended to limit, or even reverse, no-action relief recently granted by the SEC. On January 31, 2014, in what was widely viewed as a retreat from the focus on broker-dealer issues within the private equity industry, the SEC issued an important no-action letter on this issue. M&A Brokers, SEC no-action letter (pub. avail. Jan. 31, 2014). In this no-action letter, the SEC granted relief from the need for broker-dealer registration where a firm assists in the sale of a private company. Even though the firm would advise the parties on the transaction, participate in the negotiation of the transaction, and receive transaction-based compensation for these efforts, broker-dealer registration was not required. The Blackstreet case simply does not provide sufficient facts to permit any conclusions about the continued vitality of the M&A Brokers no-action letter.

Advisers Act Issues Raised in the Blackstreet Case

Record-Keeping Allegations

Blackstreet was accused of failing to keep adequate records of certain entertainment expenses paid by the funds they managed:

> From 2010 to 2013, BCM charged Fund I and Fund II each one-third of the cost of the lease and event tickets associated with a luxury suite at the Verizon Center

> in Washington, DC; BCM paid the remaining one-third of the cost. BCM and Gunty did not take sufficient steps to ensure that the costs of the lease and event tickets were allocated appropriately among BCM and the Funds. BCM and Gunty also did not adequately track or keep records of their usage of the lease or event tickets, including adequate records of personal use.

The difficulty with this charge is that the basis for this record-keeping allegation is unclear. The rules under the Investment Advisers Act of 1940 contain extensive record-keeping requirements that are imposed on registered advisers. These rules were adopted over fifty years ago and are widely viewed as out of date and unclear. Whether these rules were implicated by Blackstreet's conduct is unclear, although there is no allegation by the SEC of a violation of the record-keeping rules. If the record-keeping rules were not violated, however, it is unclear why Blacksteet was obligated to maintain records relating to entertainment expenses. If this allegation was intended to shift the burden of proving that entertainment expenses were properly paid to Blackstreet, there appears to be no legal basis for such a burden shifting.

Allegedly Inadequate "After-the-Fact" Disclosures

The Blackstreet order also contains an important allegation about the adequacy of disclosure of certain allegedly improper practices. According to the SEC, Blackstreet disclosed to investors that they were effectively paying certain expenses, but the SEC alleges these disclosures were inadequate because they came too late:

> Although BCM disclosed to the Funds' LPs that fund assets had been used to make political and charitable contributions, and to pay entertainment expenses, the disclosures were not made until after the LPs committed capital and until after the contributions were made and the expenses were incurred. BCM neither sought nor obtained appropriate consent for these expenditures.

This allegation expressly ties the adequacy of disclosures to client consent. According to the SEC, disclosure by an adviser is useless if it comes too late for clients to stop their investments in the fund. This is a strange observation for many reasons. Many disclosures are made after the events occur but are nonetheless viewed as defeating fraud charges. Indeed, the SEC's own rules for amending Form ADV disclosures do not require prospective disclosures, and for good reason. Prospective disclosures may often involve speculative guessing which would only be confusing. After the fact disclosures avoid this vice. In addition, while the Blackstreet case does not provide sufficient information to evaluate whether investors could have objected to questioned payments after the fact, and by their objections could have forced the repayment of disputed fees and expenses, it would be typical that investors would have such power to reverse questioned payments, even accepting the SEC's own connection of the adequacy of disclosure with investor power to block the disputed payments. If this is the case, it is unclear why after the fact disclosure would not defeat a fraud charge. Finally, in the private equity context, where funds operate for many years after investor capital is called, it may be impossible to anticipate every practice at the beginning of the fund. A rule that prohibits any payments that were not disclosed before investor capital is called would thus be unworkable in the private equity context.

* * *

The Blackstreet case creates more ambiguity than it resolves. This case illustrates the virtues of regulation through rule-making and the vices of regulation by prosecution. Having taken the path of regulation by prosecution, it behooves the SEC to clarify the ambiguity it has created.